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OUR CURRENT INFLATION AND MONETARY PROBLEM

With little pause after fighting and winning the most costly war in history, we are now facing a crucial battle against inflation. This is not altogether surprising. It was necessary for us to create a huge amount of money in order to finance the war and at the same time to restrict the availability of goods and services for which the public would customarily use additional money. To complicate our domestic problem there is the necessity of helping to restore the productive capacity of countries whose populations and resources have been ravished by war.

My remarks to you this evening are addressed primarily to the domestic phases of our inflation problem. Some weeks ago, in a paper that I shall be glad to make available to you, I reviewed the international phases of this problem with particular reference to Germany, a defeated enemy country. Here it is sufficient to say that the present economic difficulties of European democracy are inextricably entangled with our own problem. It would be foolhardy to deny that aiding in their reconstruction will amplify our own inflationary curve, but it would be equally foolhardy to assume that we can put our own house in order while large areas of the world are in chaos.

Without our own volition, we have been catapulted into a position of world leadership, and in the interest of our own stability and welfare, we must assume the responsibilities of this leadership. The greatest single antidote for inflation is increased production. Our own productive capacity is already running at full speed and the largest immediate reservoir of unused productive resources is in Europe. The answer to this part of our problem is clearcut. I know you will concur in my belief that we are qualified to take the measure of this problem and, in cooperation with other nations, to find constructive ways of helping devastated European countries to help themselves.

This hydra-headed problem of inflation cannot be mastered for all time by any single device or any single approach. But with a proper combination of effective policies we have reason to hope that we still can establish a lasting prosperity at home and contribute to enduring peace in the world.

We have been a little tardy in lining up our forces against inflation. Weary of the disciplines of war, we have been prone to rest on our oars and drift with the current. Inequities have already been worked on the recipients of fixed incomes by the arbitrary transfer of part of their purchasing power to classes benefiting immediately from rising prices. This process must be stopped if we are to avoid the cataclysmic consequences of a run-a-way inflation.

Extent of price inflation

During wartime, price and other controls kept our own inflationary forces under check, if not under complete restraint. It was not until after the lapse of these controls in the early summer of 1946 that inflation carried many commodity prices to new high levels. Essentially temporary shortages in supply have contributed greatly to successive spurts in the prices of many goods. The rising cost of living has necessitated widespread wage and salary adjustments that have raised production costs and justified many price increases. In many instances, however, price advances have exceeded increased costs and have helped to generate record profits.* The combination of these factors has entangled the economy in what appears to be an irresistible upward spiral of wages, costs, and prices.

Let us compare some of our current prices with those prevailing before the war. Corn before the war was selling at 45 cents per bushel, now it is $2.45. Hog prices were $6.75 per hundredweight, now they are $29.50. Cotton was 9 cents a pound and is now 32 cents. Lead prices were 5 cents a pound and now they are 15 cents. Southern pine lumber prices were $22 per thousand and now they are $80.

These are only examples of important primary commodities that have risen from 200 to 400 per cent since prewar days. In general, advances in prices of primary commodities have been much greater since the outbreak of war in 1939 than they were between 1914 and the peak of the postwar inflationary period in 1920.

The average level of all wholesale prices, including primary commodities as well as manufactured goods, is now 110 per cent above the prewar level and the retail prices of many goods have risen by almost the same proportion. Retail food prices have advanced by more than 100 per cent and clothing and housefurnishings are up 85 to 100 per cent. With rents up only 10 per cent, the rise in cost of living shown by the consumers' price index is about 65 per cent.

Prices were already high during the war and the early postwar period. When price controls were dropped last year, prices rose considerably further. Since June 1946 the average level of wholesale prices has risen 40 per cent and the cost of living 22 per cent. This spring prices showed signs of downward readjustment, but domestic and foreign developments since that time have resulted in another sharp upswing.

Inflation problems

Our sharply inflated price levels are unstable elements in the nation's economic position and the higher prices rise, the more unstable they become. This is because disparities among prices develop with inflation and become greater and greater as inflation proceeds. Thus inflation begets inflation and in the process produces economic dislocations and distortions that bear the seed of ultimate collapse and widespread unemployment.

Let us consider some of the critical tensions that attend current inflationary developments.

Prices are becoming more and more dependent on buyer's demands, which

*Cotton textile manufacturers, paper mills, lumber producers, automobile dealers and wheat farmers, to cite a few examples, are making several times the profit returns of prewar years.

in turn are dependent on other inflated prices. Inequities and discontent are multiplying. Consumption in some directions is being curtailed because the rise in prices is greater than the expansion in incomes. Price increases are making the problem of financing foreign aid and recovery particularly difficult. Foreign countries with limited dollar resources are finding the loss of purchasing power of these dollars a serious handicap.

While organized labor has been able to obtain wage increases to cover a part of the increase in living costs, the majority of consumers have been in a less favorable position. Consumers with relatively fixed incomes, especially those in the low income groups, are being forced to curtail their purchases of goods, to reduce current saving, and to draw heavily on accumulated savings. In short, they are fighting a losing battle against the cost of living.

It is important to recognize that the present upward price spiral reflects in part essentially transitory developments. These include the persistence of wartime disruptions in production and trade, deferred private demands for investment and consumption, a rapid expansion in credit extended by private organizations to business and consumers, and unusually large Government expenditures for military purposes and foreign aid. Undoubtedly, too, the upward surge of prices is being pressed by speculative forces, but the extent of this speculation will only become evident after the cumulative force of these special transitory factors has been spent.

The higher prices rise in an inflation, the more widespread and severe the subsequent readjustments are likely to be. Inevitable readjustments will affect not only prices, but production, incomes, and employment as well. The uneven character of demand, together with the special and in part temporary character of supply, has already brought striking readjustments in price relationships.

The higher production costs generated by inflation are becoming imbedded in the price structure. This development foreshadows an eventual price level substantially higher than that prevailing before the war. Since inflations tend ultimately to end in collapse and deflation, it is probable that the price level established when the liquidation of inflation is complete will be sharply below peaks reached in the present upward spiral of prices.

Breaking the inflation circle

Clearly, a primary factor in the postwar price inflation is the increase of 160 billion dollars in money and other liquid assets which occurred during the period of the war. This huge accumulation of money and liquid assets was the direct result of Government borrowing to finance war. It was essential to winning the war.

At the war's end these monetary assets represented an enormous backlog of deferred demand for goods of all types, but particularly durable goods. As a consequence, demand at current prices was far in excess of any supplies of goods that were available or could be quickly made available. The result, when wartime controls were removed, was a sharp rise in prices and the spiral of inflation that is still going on. The sooner this spiral is broken, the better off our people and our economy will be. Also, the nearer at hand will be the goal of sustained high levels of production and employment.

Today, the country's aggregate stock of money and other liquid assets exceeds 225 billion dollars, an amount about equal to the total national product. Prior to the war, aggregate liquid assets approximated only 65 billion dollars, or nearly one-third less than total product. Since redundancy of money and liquid assets is a primary factor in the present inflationary spiral, attack on this strategic factor is an essential requirement for breaking the circle of rising prices. The difficulty confronting any such attack, however, is that the existing supply of money and liquid assets is based on public debt issued to finance war.

We can only reduce the volume of Federal debt by having a budget surplus. With a Government debt of 260 billion dollars, it is clear that a surplus in any one year will not greatly reduce the total. For the current fiscal year, the President has recently estimated that we may have a budget surplus of 5 billion dollars that will be available for debt retirement. With the further rise in national income that we have been experiencing, the available surplus may exceed the President's estimate. But the new budget assumed no reduction in taxes. It also assumed no increase in Government expenditures, such as may be necessary to fulfill the nation's international obligations under the proposed program for European relief and recovery. Thus, the amount available for debt retirement this fiscal year may actually be less than currently seems possible.

Reduction in public debt through retirement from budget surpluses will be a slow process at best. Not every year will budget conditions be so favorable as this year. But it is urgent that we use debt retirement whenever possible and that we continue to do so while we are confronted by acute inflationary dangers. In the present situation, this means, of course, that moderation should be the rule to govern any immediate adjustments in our tax structure.

<u>The problem of restraining further bank credit expansion</u>

Six months ago it appeared that postwar expansion in the money supply had been effectively brought under control and that our answer to the inflation problem was to increase production to a level consistent with the existing volume of money. Since business was already operating near full capacity, however, expansion of output appeared to be a time-consuming process. Some price rise, therefore, was a method of facilitating and shortening the adjustment period and could be viewed without alarm.

We attained this leveling off in monetary expansion by using large accumulated balances of the Treasury combined with some surplus from the Federal budget to retire Government securities. The retirement program, as you know, was directed particularly at Government obligations held by commercial banks and by the Federal Reserve Banks. Retirement of obligations held by commercial banks reduced deposits directly, because Treasury deposits were exchanged for maturing bank-held Government securities. Retirement of obligations held by Reserve Banks reduced the volume of both bank deposits and bank reserves. In this case, funds were shifted from commercial banks to Federal Reserve Banks and the retirement of Government securities held by Reserve Banks cancelled a corresponding volume of member bank reserve balances. It is true that commercial banks were still free to restore reserve positions by selling other Government securities in the open market at rates kept stable by Federal Reserve System policy, and this the banks did in limited degree. But in general the pressure exerted was enough to keep further bank credit and monetary expansion under restraint.

Unfortunately, the control of postwar monetary expansion can no longer be affirmed. The total money supply is currently increasing at approximately 9 billion dollars a year. This increase in the money supply is directly inflationary and is seriously accelerating the upward spiral in prices.

The renewed expansion in the money supply is based in part on increased holdings of gold, largely received by this country in payment for exports needed by other nations. So far this year, the country's gold stock has increased by 1.8 billion dollars and imports of gold are still adding to this stock. This new gold has provided the banks with the reserves necessary to support additional deposit expansion notwithstanding the fact that the Federal Reserve has brought some pressure on reserves by selling some of its holdings of Government securities. Deposit expansion has gone on because of heavy private demands for credit from business, property owners, consumers, and State and local governments. During the first nine months of the year, bank loans increased by almost 5 billion dollars, or by almost as much as they increased during the whole of last year. The increase is still going on and, with the momentun being gathered, credit expansion can continue without check for some little time.

Therefore, our inflationary spiral problem is now not only a matter of the wartime accumulation of money and other liquid assets, but also a problem of renewed monetary expansion. Since we cannot rapidly reduce the excessive money supply that is based so largely on public debt, the least we can do is to endeavor to restrain further monetary expansion based on private debt creation.

There is unfortunately a fundamental change in the financial situation which handicaps such restraint. This fundamental change is the ability of the banking system to contineu credit expansion that the Federal Reserve System is not in a position to offset because of its responsibility for maintaining orderly and stable prices of Government securities.

The Board of Governors has given considerable thought and study to the problem presented by this fundamental change in the banking picture and has suggested several methods by which the Government securities market might be protected and traditional credit controls reestablished. These methods, which are discussed in the Board's Annual Reports to Congress for 1945 and 1946, are to empower the Federal Reserve to increase member bank reserve requirements (with the exception of raising reserve requirements from 20 to 26 percent for banks in central reserve cities, the Board of Governors has already applied the present statutory maximum reserve requirements to member banks), to introduce by statute a secondary reserve requirement against demand deposits, or, lastly, to authorize the System to limit commercial bank holdings of long-term Government securities. Chairman Eccles, in a recent speech before the National Association of Supervisors of State Banks, has underscored the importance of our changed banking problem and the urgency of finding an effective way of meeting it.

In the absence of authority to deal with the changed banking situation through one or more of these methods, there has recently been some increase in short-term rates of Government securities. But the rise in bill and certificate rates has not as yet exerted an effective retarding influence on credit expansion. As you are aware, the sheer size of the 260 billion dollar public debt, the problems of refinancing large monthly maturities, and the role of interest cost in the Federal budget are among the main reasons why short-term interest rates have not been allowed to rise more sharply. Secretary of the Treasury Snyder will announce soon action on the November 1st refunding.

The responsibility falling on the banks

Although the Federal Reserve System is handicapped by its present responsibilities, on the one hand, and by the limited scope of its authority in dealing with the present type of inflationary banking situation, on the other hand, the System will do all it can, directly and indirectly, to restrain further credit expansion. Nevertheless, a heavy responsibility devolves upon individual banks to submit to self-restraint. Under present conditions, banks are incurring large risks in private credit expansion and they should be constantly aware of these risks. Banks that conserve their credit resources and stubbornly maintain a high degree of liquidity will have less to regret and fewer losses to write off than institutions that ride the crest of the inflationary tide. This is particularly true for banks specializing in real estate and consumer credit, but it is also true for banks engaging in extensive business and agricultural lending.

A greater alertness on the part of bankers regarding the composite inflationary effects of their individual credit advances can do much to restrain the rate of current bank credit and monetary expansion. It can also do much to reduce the undesirable effects upon banks when inflation comes to an end and is followed, as it inevitably will be, by deflation. To be sure, the business of banks is to make loans and investments which accommodate industry, commerce, and agriculture, and when they discontinue this activity they cease to be true banking institutions. I am not urging banks to deny themselves their proper sphere of activity. They can reasonably be asked, however, to recognize a common responsibility in times such as these and in their self-interest to take double precautions to make loans and investments that are in every respect sound--not only sound in individual cases, but sound as related to the present inflationary economic picture.

Debt management policy

If the present spiral of rising prices is to be broken before serious damage to the economy is done, every avenue of public financial policy must be examined for whatever contribution it can make to meeting this key problem. Debt management policy is one of these avenues. Debt retirement operations in the present situation should be as anti-inflationary as possible. This means, of course, that any retirement program made possible by the current budget surplus should focus on the retirement of Government securities held by the commercial banks and the Federal Reserve Banks.

As I have said before, retirement of issues held by the Reserve Banks is more restrictive and, therefore, more anti-inflationary that retirement of issues held by commercial banks. (The Federal Reserve now holds 22 billion dollars of Government securities.) This process necessitates the adjustment of reserve positions by many banks. However, any retirement of Government securities held by banks is helpful and in the direction of restraining further credit expansion.

Another important phase of debt management policy would be to increase the sale of long-term bonds to investors and to use the proceeds to retire part of the debt held by banks. Important banking and other groups have strongly urged such a program and recently the Treasury has taken an important step to implement the suggested policy. I refer, of course, to the new Series A nonmarketable investment bonds. Further experience along these lines is desirable.

Maintenance of as high a level of sales of savings bonds as possible will also need to be an essential aspect of an effective debt program designed to help check the inflationary spiral. The vast majority of American families strongly believe that regular saving is important, and more than half of all families think that saving is even more important now than it was during the war. This is one of the significant findings of the Board's recent surveys of consumer finances. It lends substance to the belief that a continuing flow of funds will be available to the Treasury from sales of savings bonds in excess of redemptions, even though personal savings are lower in volume than in war years. The amounts in any one year will probably not be large, but they will help to transfer securities from banks to nonbank investors in accordance with desirable debt management policy. Again, consideration must be given to the use of these funds to retire bank-held obligations in the way that will be most anti-inflationary.

It is clear that debt management policy can serve constructively to check the present price spiral by helping to restrict further monetary expansion. It is clear too that the inflationary situation is serious enough to warrant as much use of such policy as is feasible. The actual working out of policy appropriate to current conditions, is, of course, a highly technical matter. The subject is under continuing study by the Board, the System's Open Market Committee, and the Treasury, and the effective liaison that exists between the authorities assures that every suggestion or alternative will receive careful study and consideration.

Conclusions on domestic inflation and monetary policies

Economic stability at high levels of employment and output is seriously threatened by the current inflationary spiral. One of the main causes of this inflationary condition is the excessive money supply created by war finance. Expansion in the money supply under the pressure of forces that are largely domestic, but to some extent international, in origin is being resumed. Meanwhile, the demand for available supplies of goods and services is driving prices higher. If the inflationary spiral is to be broken, it is imperative that the world supply of goods and services be expanded as rapidly as possible. Today the greatest available supply of unused resouces is in Europe and it should be developed without delay.

Fiscal, debt management, and monetary policies must also be brought to bear on the inflationary spiral.

At least, it is urgent to restrain further expansion in the money supply. Maintenance of a large budgetary surplus is essential for this purpose. This can be accomplished, however, only by holding taxes up and governmental expenditures down so far as is possible under existing conditions.

Monetary policies should be directed to keeping in check further bank credit and deposit expansion. Not much can be done through Federal Reserve policies, however, in the existing situation. Therefore, individual banks have to assume a greater responsibility for credit expansion, to recognize more fully the composite effects of their actions, and to take account more directly of the abnormally high risks that are involved in current credit extensions.

Public debt management policy should be as anti-inflationary as circumstances permit. Emphasis on retirement of bank-held Government securities is essential and every feasible measure for transferring Government securities out of the banks into the hands of nonbank investors should be applied.

The task of breaking the present inflationary spiral through fiscal debt management, and monetary policies may not prove insuperable. If successful, however, the attack will require the full cooperation with Government of all banks, financial institutions, and businesses. And if it is not successful, our private banking system may once more be the scapegoat in the eyes of the public. First, it may be held responsible for having caused inflation. And second, it may be accused of having caused the collapse and deflation which, if history is any guide to future events, will at some stage inevitably come unless prudent realistic measures are applied in all quarters without delay.